ENT-68 APPLY MEANS TESTS TO FEDERAL ENTITLEMENTS

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Make Entitlements Subject to Individual Income Tax						
Non-Means-Tested Entitlements	16,000	46,200	49,500	53,200	57,200	222,100
All Entitlements	18,600	55,100	59,600	64,600	70,000	267,900
Reduce Entitlements Provided to Middle- and High-Income Families						
Non-Means-Tested Entitlements	10,100	47,800	45,000	48,600	52,400	203,900
All Entitlements	10,100	50,900	48,400	52,400	56,700	218,500
Deny Entitlements to High-Income Recipients						
Non-Means-Tested Entitlements	4,300	10,400	9,600	10,300	11,100	45,700
All Entitlements	4,300	10,400	9,700	10,500	11,400	46,300

SOURCE: Congressional Budget Office.

NOTE: Estimates do not include administrative costs or revenue losses from reductions in taxable benefits.

There are two basic approaches to constraining entitlement spending. One broad strategy would reduce the growth of spending (or tax the benefits at higher rates) on a program-by-program basis. New program rules or tax laws could limit who qualifies for benefits, reduce the amount of benefits provided, or change the taxation of benefits. (Examples of this kind of approach include ENT-48, ENT-49, ENT-60, ENT-63, ENT-67, REV-15, and REV-17.)

An alternative to the program-by-program approach would constrain entitlements as a group through some form of means-testing under which benefits would be cut most for beneficiaries with the highest income. Three illustrations of that method are discussed here. The first approach would subject most entitlement benefits to federal individual income taxes, the second would reduce benefits as beneficiaries' income rises, and the third would deny benefits to individuals with income above specified thresholds. The savings attributed to those three approaches would be smaller than shown here if the Congress enacted one or more of the program-by-program approaches described in other options.

Some federal entitlements are already subject to limits on income or wealth under program regulations. The federal part of Supplemental Security Income (SSI) is available only to elderly and disabled people with monthly income below federally specified national limits. Aid to Families with Dependent Children (AFDC) goes only to families with children who have monthly income below limits set by individual states. Recipients of SSI and AFDC are automatically eligible for Medicaid, as are certain people with low family income. Only households with monthly income below the federal poverty guidelines qualify for food stamps. Because those and other means-tested programs currently provide benefits only to people with low monthly income, subjecting them to any of the three methods of means-testing discussed here would duplicate the current means-testing at significantly higher income levels, imposing administrative and compliance costs and having little effect on net saving. At the same time, because each of the alternative approaches would impose an annual means test--as opposed to the monthly tests now used in each program--beneficiaries who qualify for assistance for only part of a year could lose some or all of their benefits. Budgetary savings for each approach are shown both including and excluding those transfers that are already means-tested.

Non-means-tested entitlement programs included here are Social Security and Railroad Retirement, Medicare, unemployment compensation, and veterans' benefits. Since Social Security and Medicare account for the bulk of entitlements, the options discussed here largely affect the elderly. The analysis excludes two other major entitlement programs--federal civilian and military pensions--because they are part of the labor contract between the government and its employees and not transfers in the same sense that the included programs are. Several options to constrain spending on these two excluded programs are discussed in ENT-50.

Means-testing could be based on individual income, income of couples, or the income of a more broadly defined family. The unit used determines which recipients would be affected by the alternative approaches, as well as how recipients might respond to means-testing. Because families generally consume as a unit, family income and wealth are probably better measures of need than individual income and wealth. Further, the family measures are greater than the individual measures, so applying the same dollar thresholds in means tests to families rather than individuals would affect more recipients. At the same time, depending on how the means tests are structured, basing the tests on families could induce families to split up into smaller units to minimize benefit reductions. For example, in the approach to benefit reduction discussed below, a retired couple in which each spouse had $20,000 of pension and investment income and $10,000 of Social Security would lose $3,000 of their Social Security benefits; if they divorced, they would keep all of their benefits. Appropriate differentiation of benefit reductions for individuals and families of different sizes could reduce or remove such incentives for family breakup.

A significant objection to global means-testing of entitlements is that different programs serve different purposes. Individual programs provide people with separate types of in-kind consumption, such as food, housing, and medical care. Society may wish to ensure fuller access to those goods and services rather than simply provide more cash income. In that view, any limit on benefits should be imposed on a program-by-program basis to allow different criteria to be applied.

Reducing entitlements to medical assistance raises special concerns. One problem is valuing medical services in dollar terms. One approach would base value on benefits actually received. That approach could yield unacceptable results because it would assign the highest values to the sickest people receiving the most care. Another approach would count the federal subsidy to in-kind programs as benefits. In Medicare, for example, the subsidy would be the implicit value of an insurance premium paid for by the government.

Means-testing benefits also poses a transitional problem, particularly for retirees. Recipients of benefits may have made financial decisions and plans expecting particular incomes from entitlements. Changing those benefits could impose hardships. Phasing in taxation of benefits or means tests over time would mitigate that difficulty.

Make All Entitlements Subject to Individual Income Tax. Under current law, some benefits of federal entitlement programs, such as unemployment compensation and military pensions, are fully subject to individual income taxes; others, such as Social Security, are partially so; and still others, such as Medicare and food stamps, are entirely excluded from taxable income. One approach to means-testing all entitlements would include in taxable income all federal entitlement benefits in excess of contributions made for specific programs. Thus, for example, the insurance value of Medicare in excess of premiums paid for Supplementary Medical Insurance coverage would become part of a recipient's taxable income. Program administrators would tell recipients annually the net value of benefits to report as taxable income, using a form 1099-G similar to the forms used to report dividend and interest income. Such inclusion for all entitlements would increase revenues by about $18.6 billion in 1996 and $267.9 billion from 1996 through 2000.

Taxing entitlements recognizes that entitlements increase a recipient's ability to pay taxes in the same way that other forms of income do. Excluding some entitlement payments from taxable income simply because they come from the government could be viewed as violating the principle that taxes should be higher for people with higher income. A counterargument, however, asserts that entitlements are not taxable now simply because benefit levels are set to be net of taxes. If those levels are too high, the Congress should reduce them within each individual program. Making benefits taxable does have the advantage of providing a straightforward annual measure of recipients' needs for federal assistance. Even so, it could be difficult to justify including noncash benefits received from the government, but not those provided by employers. That last objection is not an issue, however, if taxing benefits is viewed as a means of allocating scarce government resources to the most needy recipients.

Reduce Benefits Provided to Middle- and High-Income Families. The Concord Coalition has proposed that federal entitlement benefits be reduced rapidly as income rises. Benefit reduction could be achieved either through supernormal tax rates imposed under the individual income tax or directly through new programmatic structures. Under the Concord Coalition's proposal, families with income above $40,000 would lose benefits under a graduated scale beginning at 10 percent for those with income between $40,000 and $50,000 and increasing by 10 percentage points for each $10,000 of income up to 85 percent of benefits above $120,000 of total income. Nontransfer income would be considered first in determining the rate of benefit reduction, and benefits would be reduced only to the extent that they caused total income to exceed $40,000. For example, a family receiving $15,000 of Social Security and $30,000 of nontransfer income would lose $500 of benefits--10 percent of the $5,000 by which total income exceeds $40,000. If the family had $45,000 of nontransfer income, it would lose $2,500 of its Social Security--10 percent of the $5,000 that falls in the $40,000 to $50,000 income range and 20 percent of the $10,000 that falls in the $50,000 to $60,000 income range. A family with nontransfer income above $120,000 would have its benefits reduced by 85 percent. (Under the Coalition's plan, married couples and larger families would face the same income limits as single people, and all dollar values would be indexed for inflation.)

This option would reduce benefits for all entitlements by about $10 billion in 1996 and about $219 billion from 1996 through 2000. Compared with the option that would tax benefits, this proposal to reduce benefits would have no effect on families with lower income and a greater effect on families with higher income.

This approach reflects the view that entitlements should go primarily to those most in need of them, not to families with higher income. Imposing the same criteria for establishing need among all entitlement programs might be the fairest way to limit benefit payments. A global approach to benefit reduction could also be less costly to administer than an approach that addresses each program individually, although whether it would cost less depends in large part on whether new administrative apparatuses would have to be created.

A significant problem with this option is the disincentive for families to save and earn other income that is created by the rapid reduction in benefits as income rises. That effect would be mitigated somewhat, however, if the benefit reduction was phased in gradually over a wide income range. Recipients with income well above the $120,000 level at which benefit reduction is greatest would face smaller or no disincentives, since they would have to lower their income greatly to incur a smaller benefit reduction. An alternative to forgoing income to lessen benefit reductions would be to shift income to sources that would not be counted in the benefit reduction formula. For example, if interest on tax-exempt bonds was not counted, entitlement recipients would be expected to shift their investments into those bonds. Such behavior could be limited, however, by counting as many forms of income as possible in determining benefit reductions.

Deny Entitlements to High-Income Recipients. Some Members of Congress have recently considered a third approach to means-testing entitlements that would deny completely any entitlement payments to recipients with income above specific limits. The budgetary savings shown assume limits of $100,000 for single recipients and $120,000 for married couples, with benefits phasing out over a $10,000 income range. This option would reduce spending on all entitlements by $4.3 billion in 1996 and $46.3 billion over a five-year period. Compared with the proposal of the Concord Coalition to reduce benefits, this option would exempt middle-income families from benefit cuts and impose larger benefit reductions on families with the highest income.

This approach has many of the advantages of and problems faced by the alternative that would simply reduce benefits. Because benefits would be phased out over a narrow income band, however, the work and saving disincentives would be significantly greater for people with income near the cutoff level. Families with more than $10,000 in benefits and income in the phaseout range would face marginal tax rates of more than 100 percent from this provision alone. The narrower the band, the more likely would be potential recipients with income in or just above the phaseout range to adjust the timing of their income receipts, forgo savings, or reduce work effort to stay under the income limit. At the same time, because beneficiaries with income below the phaseout range would continue to receive full benefits, many fewer recipients would face work and saving disincentives than in the approach that would reduce benefits over a broad income range. Any reduction in work effort or savings would reduce the budgetary savings. Finally, this approach would also create incentives to shift income to sources excluded from the income calculation.

ENT-69 CHARGE FEDERAL EMPLOYEES COMMERCIAL RATES FOR PARKING

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Budget Authority	100	110	110	110	110	540
Outlays	100	110	110	110	110	540

The federal government leases and owns more than 200,000 parking spaces, which it allocates to its employees--in most cases, without charge. Requiring employees of the federal government to pay commercial rates for their parking could reduce the deficit by $540 million through 2000.

The vast majority of federal workers park without charge. For example, one survey of 10 agencies in Washington, D.C., found that 71 percent of federal workers who received parking from their agencies received it free of charge. Employees of the Congress also received free employer-provided parking. Federal workers who pay for parking are almost always charged less than the commercial rate, although federal agencies, with the approval of the General Services Administration, are allowed to charge their employees the higher commercial fees. Some Members of Congress support charging all federal employees parking fees set at commercial rates, an idea similar to a proposal made by President Carter. The Clinton Administration has also proposed greater incentives for agencies to charge higher rates for parking spaces.

Federal workers in the largest metropolitan areas would bear the brunt of these new charges. Those in the Washington, D.C., metropolitan area would be affected most, paying about 75 percent of the total charges. Federal employees in less commercially developed areas--where charging for parking is uncommon--would not face new fees. The estimated savings rely on the best available information about the number of federal parking spaces, commercial parking rates, and expected declines in the demand for parking by federal workers as a result of higher rates. Once commercial rates were instituted, however, future parking rates, the number of spaces controlled by the federal government, and responses by federal workers could vary unexpectedly.

In 1992, the Congress passed an energy policy law that contained a provision to include as taxable income the commercial value of any parking provided free of charge by an employer--including the federal government--in excess of $155 per month (indexed for inflation beyond 1993). Paying for parking at commercial rates would reduce the gross income of such employees; however, the estimate of savings from this option does not include the reduction in tax revenues that would result, because available data do not allow an estimate of the option's effect on revenues. Analysts agree, however, that the offsetting reduction in revenues would be relatively small.

Proponents of charging commercial rates for employer-provided parking argue that subsidized parking increases the frequency with which workers drive to work, especially in single-occupancy vehicles. Those observers believe that higher prices for parking would decrease the flow of cars into urban areas by encouraging the use of public transportation or car pooling. In turn, they argue, a reduction in the number of cars would reduce energy consumption, air pollution, and congestion.

Some supporters of charging fees also maintain that the federal government would be acting as a model employer and could call more effectively on others to reduce pollution and energy consumption. In addition, charging commercial prices for parking would show more accurately the demand for parking by federal workers. At commercial rates, the supply of employer-provided parking may well exceed demand, which could lead to alternative uses of current parking space. Moreover, commercial pricing would allocate spaces to those who valued them the most, thereby setting aside differences in income. Finally, some observers argue that the federal government can no longer afford to provide valuable goods and services free of charge to workers who can afford to pay for them.

Opponents of full-cost pricing for parking argue that it would unfairly penalize workers in urban areas who have difficulty obtaining access to alternative transportation or who drive to work for valid personal reasons. In the view of those critics, charging commercial rates for parking for federal workers effectively represents a cut in total compensation and is inappropriate, given other proposed reductions in federal employment and compensation. Some critics have also argued that free parking is a common form of compensation in the private sector. (However, in the Washington, D.C., metropolitan area, only 37 percent of parking spaces for private-sector workers were provided free of charge in 1991; 46 percent were priced at the full commercial rates.) In addition, some people argue that the new charge will simply change the mix of federal employees using the parking spaces--higher-income employees will be favored over lower-income ones. Now, the allocation of parking spaces in many agencies is based on rank, seniority, or other factors; instituting fees for parking would ration spaces to employees who were willing to pay commercial rates.

If the funds collected from charging commercial rates for parking were used to finance other spending, the savings noted earlier in this option would be smaller or zero. The Administration, for example, has supported new incentives for agencies to charge higher rates for parking in order to subsidize the use of mass transit by their workers. That proposal would neither reduce nor enlarge the deficit because agencies would not rebate the fees to the Treasury but instead provide them to transit-using employees. The funds raised by this option would be counted as offsetting collections or offsetting receipts, depending on how the option was applied.

ENT-70 MAKE PERMANENT VARIOUS EXPIRING USER FEES INCLUDED IN THE OMNIBUS BUDGET RECONCILIATION ACTS OF 1990 AND 1993

Addition to Current-Law Receipts	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Patent and Trademark Fees	0	0	0	119	119	238
Vessel Tonnage Charges	0	0	0	49	49	98
Rail Safety Fees	42	43	45	47	49	226

The Omnibus Budget Reconciliation Acts of 1990 and 1993 (OBRA-90 and OBRA-93) included provisions creating user fees for a variety of services that the federal government provides to private parties. OBRA-90 enacted rail safety fees for the years 1991 through 1995. OBRA-93 levied fees on vessel tonnage and imposed patent and trademark fees that will expire in 1998. Extending these fees could raise $562 million in receipts for 1996 through 2000, providing offsetting receipts in the budget functions designated for commerce and transportation.

The general argument for user fees applies to each of the proposals included in this option; namely, that the recipients of government services should bear the cost of those that clearly benefit a specific group. Accordingly, patent and trademark fees are established to cover the cost of providing services to would-be holders of a patent or trademark. The vessel tonnage fee is collected on all vessels entering a U.S. port and helps support the general operations of the Coast Guard. The fees charged railways offset the cost of the government's railway safety activity.

Antithetically, it can be argued that services provided by government ultimately benefit the general populace and should be paid for by all taxpayers rather than a specific group. Those who advocate the repeal of specific fees argue that charges were unevenly applied among users or, directly or indirectly, inflicted undue costs on payers.

Chapter Five

Revenues

The start of a new Congress provides an opportunity to reexamine how the federal government goes about raising revenue. Although the Congress is currently interested in tax reductions and tax reforms, the objective of reaching a balanced budget by 2002 could force consideration of revenue-raising measures as part of those reforms. This chapter presents 39 revenue-raising options that would affect taxpayers at all income levels and include all of the major revenue sources.

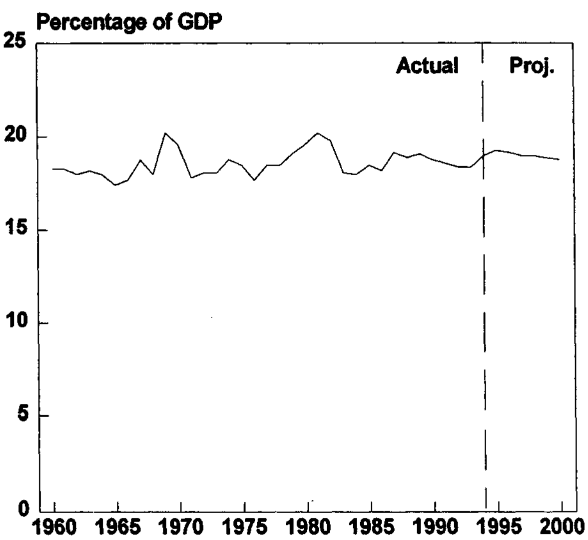
Federal revenues were $1.26 trillion in 1994 (see Table 5-1). With no change in current policies governing taxes, nominal revenues will grow to $1.36 trillion in 1995 and $1.7 trillion by 2000.

Currently, about 90 percent of federal revenue comes from income and payroll taxes. In 1994, the individual income tax raised 43 percent of federal revenue, the payroll tax 37 percent, and the corporate income tax 11 percent. Excise taxes raised an additional 4 percent of federal revenue. The rest came from estate and gift taxes, customs duties, and fees and other miscellaneous receipts.

Federal revenues in 1994 claimed 19 percent of gross domestic product (GDP). If the Congress enacts no new legislation affecting revenues, the Congressional Budget Office expects the revenue share of GDP to average 19 percent over the next six years.

Since 1960, the revenue share of GDP has dropped as low as 17.4 percent and risen as high as 20.2 percent, with an average value of 18.6 percent (see Figure 5-1). The revenue share surpassed 20 percent in the late 1960s when the Congress enacted an income tax surcharge during the Vietnam War, and again in 1981 after several years of rapid inflation pushed taxpayers' incomes into higher tax brackets ("bracket creep"). Large personal and corporate tax reductions enacted in the Economic Recovery Tax Act of 1981 (ERTA), combined with back-to-back recessions in 1980 and 1981-1982, brought the revenue share down to about 18 percent in 1983. ERTA also removed inflationary bracket creep from the personal income tax by enacting--starting in 1985--indexing for inflation of the personal income tax bracket amounts, the standard deduction, and the personal exemption. In subsequent years, the revenue share of GDP, bolstered by sustained economic growth and deficit reduction measures, climbed to

Figure 5-1.
Total Revenue as a Share of GDP



SOURCE: Congressional Budget Office.

19.1 percent in 1989. As a result of the 1990-1991 recession and the slow recovery that followed, the revenue share fell to 18.4 percent in 1992 and 1993 before rebounding to 19 percent in 1994 as the economy improved and the tax increases enacted in the Omnibus Budget Reconciliation Act of 1993 took effect.

Over the last 35 years, important shifts have occurred in the major sources of revenue--individual, social insurance, corporate, and excise taxes (see Figure 5-2). Individual income taxes--the largest component of total revenues--have risen and fallen as a share of GDP since 1960, but are currently near their average level of 8.4 percent. The individual income tax share of GDP exceeded 9 percent in 1969 and 1970, when Congress enacted an income tax surcharge, and again in the 1979-1982 period, when rapid inflation led to bracket creep that pushed up revenues. Individual income taxes peaked at 9.6 percent of GDP in 1981. Their share of GDP bottomed out at 8 percent in 1992, following the 1990-1991

Table 5-1.
CBO Baseline Projections for Revenues, by Source (By fiscal year)

Source	Actual 1994	1995	1996	1997	1998	1999	2000
			In Billions of Dollars				
Individual Income	543	594	628	656	693	731	772
Corporate Income	140	149	151	155	161	167	173
Social Insurance	461	494	517	539	565	590	618
Excise	55	56	56	57	58	59	59
Estate and Gift	15	16	17	18	19	19	20
Customs Duties	20	21	21	21	21	22	23
Miscellaneous	22	25	28	29	30	30	31
Total	1,257	1,355	1,418	1,475	1,546	1,618	1,697
On-budget	922	998	1,043	1,084	1,135	1,187	1,245
Off-budget[a]	335	357	375	392	411	431	452
			As a Percentage of GDP				
Individual Income	8.2	8.4	8.5	8.5	8.5	8.5	8.6
Corporate Income	2.1	2.1	2.1	2.0	2.0	2.0	1.9
Social Insurance	7.0	7.0	7.0	7.0	6.9	6.9	6.9
Excise	0.8	0.8	0.8	0.7	0.7	0.7	0.7
Estate and Gift	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.3	0.4	0.4	0.4	0.4	0.4	0.3
Total	19.0	19.3	19.2	19.0	19.0	18.9	18.8
On-budget	13.9	14.2	14.2	14.0	13.9	13.9	13.8
Off-budget[a]	5.1	5.1	5.1	5.1	5.0	5.0	5.0

SOURCE: Congressional Budget Office.

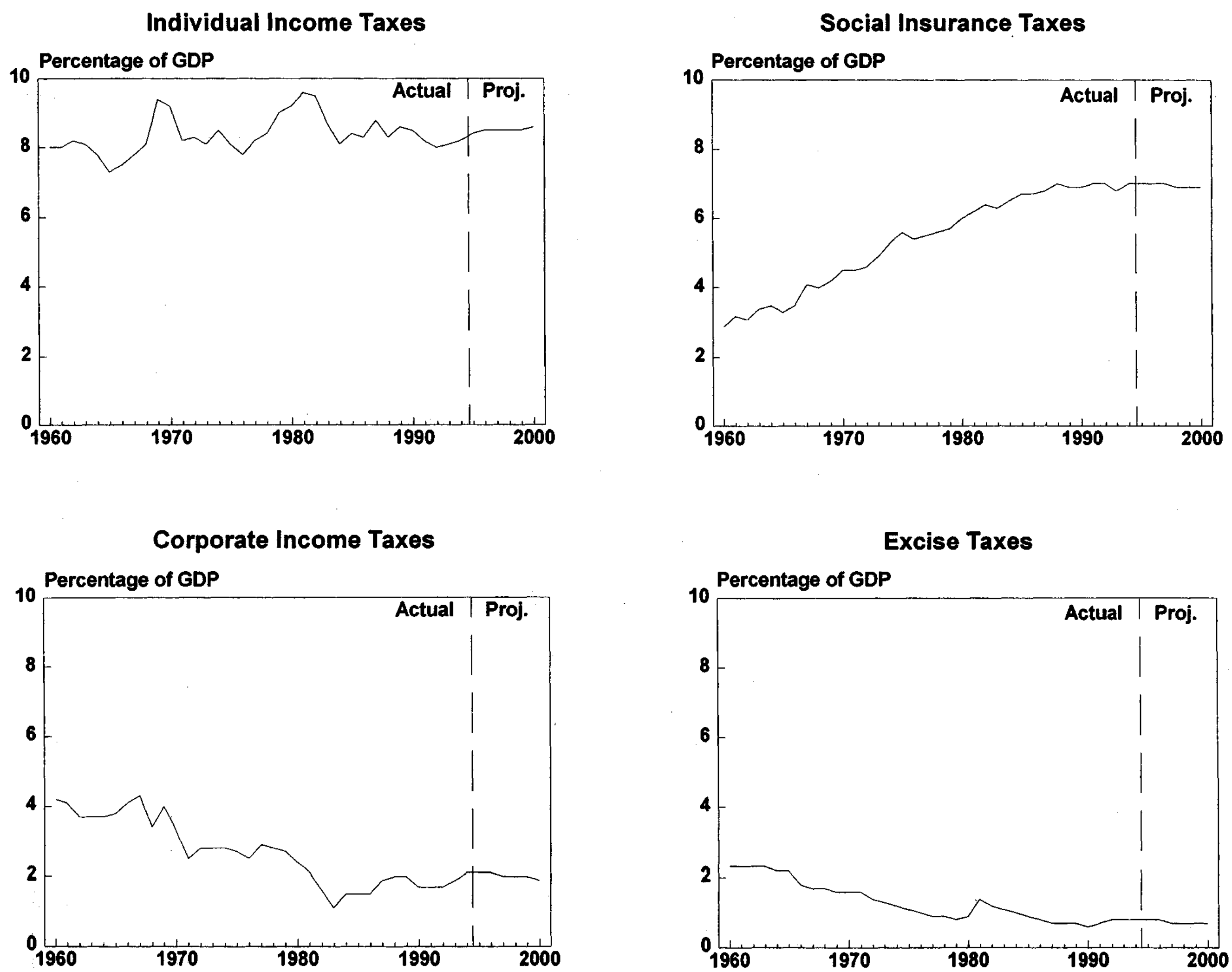
a. Social Security.

recession, the lowest level since 1976, after the 1974-1975 recession. Barring any new legislation affecting revenues, CBO expects that individual income tax revenues will claim about 8.5 percent of GDP for the remainder of the decade.

The share of GDP claimed by corporate income taxes fell between 1960 and the mid-1980s because of both a drop in corporate profits as a share of GDP and legislated reductions in tax liability. The share averaged just below 4 percent in the 1960s, just below 3 percent in the 1970s, and just below 2 percent in the 1980s. Corporate taxes as a share of GDP have grown slightly since the Congress raised corporate taxes in the Tax Reform Act of 1986. Hence, CBO expects that the revenue share of corporate taxes will average 2 percent of GDP from 1995 through 2000.

The share of GDP claimed by social insurance taxes (mostly Social Security) increased steadily between 1960 and the late 1980s as tax rates, coverage, and the share of wages subject to taxation all grew.

Figure 5-2.
Revenues by Source as a Share of GDP



SOURCE: Congressional Budget Office.

The share swelled from nearly 3 percent of GDP in 1960 to 7 percent by 1988, about where it is today. Revenues from social insurance taxes equaled about 30 percent of combined individual and corporate income tax revenues in the 1960s, 60 percent of combined income tax revenues in the 1980s, and about 70 percent today.

Excise taxes represent only a small share of federal revenues. They have claimed a decreasing share of GDP over time largely because most are levied on the quantity, not the value, of goods, and in general rates have not been raised enough to keep pace with inflation.

This chapter presents a broad range of options for increasing federal revenue. The options would raise revenue from all of the major revenue sources. But they differ in the way they would affect the allocation of economic resources among alternative uses and the distribution of tax burdens among taxpayers.

Some Members of Congress are interested in more dramatic changes in the way revenue is raised. Indeed, interest in structural changes in the tax system has persisted for a long time. As Henry Aaron, Harvey Galper, and Joseph Pechman wrote in 1988 in the introduction to *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*:

> For decades U.S. tax experts have been debating whether the nation would be better served by an income tax or by a consumption tax. Both taxes would apply to total household resources and both taxes can be levied at graduated rates. The essential difference is that the consumption tax exempts saving, while the income tax does not.[1]

Some of the tax proposals that the Congress may consider this year would move the present income tax system closer to a consumption tax--for example, neutral cost recovery is proposed in the Contract with America supported by the Republican majority in the House of Representatives. Some proposals would go even further than neutral cost recovery. Many Members of Congress have expressed interest in a full or partial replacement of income taxes with a consumption tax, citing increased national saving and reduced complexity of the tax system as some of the potential advantages of such a switch. Whether such a major restructuring will eventually be put in place depends on how well an actual consumption tax system would produce those advantages while meeting other important criteria such as revenue capacity and equity among taxpayers.

Neither the individual income tax nor the corporate income tax in place today is a pure tax on income. Each tax combines elements of both income and consumption taxation. For example, saving through employment-related pensions, 401(k) plans, and, for some workers, individual retirement accounts is tax-exempt under the current income tax, just as it would be under a consumption tax. Although not fully tax-exempt as under a consumption tax, investment generally receives more favorable depreciation treatment under the present income tax than it would under a pure income tax. Both the individual and corporate income tax have features that are not compatible with either pure income or pure consumption taxation--features designed to further other policy goals. For example, the deduction of contributions to charity under the income tax encourages charitable activities, and the exemption of employment-related health insurance premiums helps to broaden health insurance coverage. Such features address widely accepted social objectives and might well also be included in a consumption tax enacted to replace the present income tax system.

In reviewing the options presented in this chapter, try to determine whether they are consistent with an income- or consumption-based tax system or both. A number of options would raise revenues by moving toward more comprehensive income taxation--for example, limiting tax preferences for retirement saving (REV-12 and REV-13), capital gains (REV-21 and REV-22), and life insurance and annuities (REV-16). Options consistent with a shift toward consumption-based taxes include introducing a value-added tax (REV-33) or a broad-based energy tax (REV-34). A third set of options would raise revenues by eliminating or curtailing preferences in the tax code--for example, taxing employment-related health and life insurance benefits (REV-10 and REV-11) or lim-

1. Henry Aaron, Harvey Galper, and Joseph Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: Brookings Institution, 1988).

iting itemized deductions for home mortgage interest, state and local taxes, and charitable contributions (REV-04, REV-05, and REV-06). Those options would be consistent with a comprehensive tax on either income or consumption.

The options differ in their implications for the cost of administration by the Internal Revenue Service and the cost of compliance by taxpayers. Some would raise revenue from existing tax sources by increasing tax rates, broadening tax bases, or expanding tax coverage to include additional taxpayers. The government could put many of those options into place quickly and easily because the taxes are already in place. Other options would raise revenue from new tax sources such as a federal value-added tax or a broad-based energy tax. Those options could impose substantial additional compliance costs on taxpayers and administrative costs on the federal government because they would require additional methods for computing taxes and more Internal Revenue Service employees.

One revenue-raising option--to make all entitlement payments subject to the individual income tax--appears not in this chapter but in Chapter 4, which discusses entitlement payments and other mandatory spending. That option is part of the ENT-68 option, which would apply a means test to federal entitlement payments.

Although most of the spending options presented in this volume would take effect on October 1, 1995, all but one of the revenue options would take effect on January 1, 1996. The option for a value-added tax has a later effective date because implementing the tax would take more time. The revenue estimates for the options, most of which the Joint Committee on Taxation prepared, may differ from estimates for similar provisions in actual tax legislation because of differences in effective dates, transition rules, and technical details.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS AND CORPORATIONS

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
			Individuals			
Raise Marginal Tax Rates to 16 Percent, 30 Percent, 33 Percent, 38 Percent, and 42 Percent, and Top AMT Rate to 30 Percent	24.5	42.1	44.0	46.2	48.3	205.1
Raise the Top Marginal Tax Rates to 38 Percent and 42 Percent	4.1	6.9	7.1	7.5	7.7	33.3
			Corporations			
Raise the Top Marginal Tax Rate to 36 Percent	1.7	3.4	3.5	3.8	3.8	16.2
Raise the AMT Rate to 25 Percent	1.3	3.0	2.9	2.5	2.3	12.0

SOURCE: Joint Committee on Taxation.

NOTE: AMT = alternative minimum tax.

Rate increases have some administrative advantages over other types of tax increases because they require relatively minor changes to the current tax collection system. But rate increases have drawbacks as well. Higher tax rates can reduce incentives to work and save, and encourage taxpayers to shift income from taxable to nontaxable forms (such as substituting tax-exempt bonds for other investments or tax-free fringe benefits for cash compensation) and to increase spending on tax-deductible items such as home mortgage interest and charitable contributions. In those ways, they exacerbate economic inefficiencies.

Individuals. Under current law, five explicit marginal tax rates apply to taxable income: 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. (The marginal tax rate is the percentage of an extra dollar of income that a taxpayer must pay in taxes.) The maximum marginal tax rate on capital gains income is 28 percent. Some taxpayers face effective marginal rates higher than the top rate of 39.6 percent because of provisions that phase out their itemized deductions and personal exemptions. For 1995, the levels of taxable income at which the marginal rates apply are shown in Table 5-2.

Increasing all marginal tax rates on ordinary income to 16 percent, 30 percent, 33 percent, 38 percent, and 42 percent (approximately a 7 percent increase) would raise about $205 billion in 1996 through 2000. This option would also increase the top marginal tax rate under the alternative minimum tax (AMT) to 30 percent in order to keep the rate aligned with the regular tax rates and avoid a major shift of payments between the AMT and regular tax. The AMT is now imposed on individuals at rates of 26 percent and 28 percent on a broader base. Individuals pay the larger of the AMT or the regular tax. Under this option, families with tax credits would face a somewhat larger percentage increase in their tax liabilities than other taxpayers, and families whose earned income tax credit gives them a tax refund might have to pay tax. (This option and the next one assume that the maximum rate on capital gains would remain at 28 percent.)

Another option is to increase only the top two marginal tax rates. Increasing the current 36 percent rate to 38 percent and the 39.6 percent rate to 42 percent would raise revenues by about $33 billion in 1996 through 2000. For 1996, this option would increase taxes for married couples with taxable income of more than $147,950 and single filers with taxable income of more than $121,550. The change would affect just over 1 percent of tax filers.

The estimates assume that taxpayers will change their behavior in a variety of ways if marginal tax rates are raised, chiefly by shifting income from taxable to nontaxable or tax-deferred forms. The estimates do not assume any change in total hours worked. Increasing all marginal tax rates may have little effect on hours worked because of offsetting incentives. Since higher tax rates reduce the returns from working (each hour of work produces less take-home pay), workers may be unwilling to work the same number of hours as before. But since higher tax rates also reduce after-tax income, taxpayers may wish to work more in order to maintain the same level of disposable income.

Increasing only the top two marginal tax rates might have a greater effect on hours of work. Taxpayers with taxable income just above the level at which the new rates would apply would see little reduction in their after-tax income, but they would experience a decrease in the return from working additional hours. As a result, they would most likely cut back on hours of work, which would reduce some of the revenue pickup from the increase in rates.

Table 5-2.
Individual Income Tax Brackets, 1995 (In dollars)

Taxable Income for Single Filers	Marginal Tax Rate (Percent)	Taxable Income for Married Couples
0 to 23,349	15.0	0 to 38,999
23,350 to 56,549	28.0	39,000 to 94,249
56,550 to 117,949	31.0	94,250 to 143,599
117,950 to 256,499	36.0	143,600 to 256,499
256,500 and Over	39.6	256,500 and Over

SOURCE: Internal Revenue Service.

NOTE: Separate schedules apply for taxpayers who are heads of households or who are married and file separate returns.

Corporations. The tax rate for corporations is 15 percent on taxable income up to $50,000, 25 percent on income from $50,000 to $75,000, 34 percent on income from $75,000 to $10 million, and 35 percent on income above $10 million. The tax benefit from the 15 percent, 25 percent, and 34 percent rates is recaptured for corporations with income above certain amounts by an additional 5 percent tax that is levied on taxable income between $100,000 and $335,000 and a 3 percent additional tax on income between $15 million and $18.3 million (see REV-03).

Corporations also face the alternative minimum tax, which limits their use of tax preferences. When computing taxable income for the alternative minimum tax, taxpayers may not make certain adjustments that are otherwise allowed in computing regular taxable income. Those adjustments are of two types: deferral preferences, such as accelerated depreciation, excess intangible drilling costs, and profit or loss from long-term contracts; and exclusion preferences, such as some tax-exempt interest and percentage depletion. As with individuals, corporations must pay the larger of the regular tax or the AMT and can use one year's AMT as a credit against regular tax liability in future years. (Individuals can only use as credits the portion of the AMT that arises from deferral preferences.) Thus, a portion of the revenue gain from a higher AMT rate would result from a shift of some future tax liabilities to earlier years.

Increasing the top marginal rate for corporations to 36 percent would raise about $16.2 billion in 1996 through 2000. Out of approximately 1 million corporations that have positive corporate tax liabilities each year, fewer than 3,000 pay income taxes at the top rate and would be affected by this option. Nonetheless, those firms earn approximately 80 percent of all corporate taxable income. The change would not, however, affect corporations that always pay the AMT. Moreover, those corporations paying the regular tax, but with unused credits, could offset some of the tax increase.

Boosting the corporate AMT rate to 25 percent would raise about $3 billion in 1997 but decreasing amounts thereafter because the revenue raised represents a shift of future liabilities to earlier years, as described earlier. Proponents of the corporate AMT argue that it improves the perceived fairness of the tax system because it largely ensures that corporations reporting profits to shareholders pay the corporate tax. Critics maintain, however, that the corporate AMT places a greater tax burden on rapidly growing and heavily leveraged corporations and provides corporations with an incentive to engage in tax-motivated transactions. For example, a firm that expects to pay the AMT may be able to reduce its tax by leasing its equipment rather than owning the equipment and using the accelerated depreciation tax preference.

Relationship Between Top Rates Affects Business Form. Changes in the difference between the top corporate and individual tax rates affect the form of organization a business chooses. Owners of corporate businesses pay both the corporate and individual income tax on their business income, whereas owners of noncorporate businesses pay tax only at the individual level. At present, the top individual tax rate is above the corporate tax rate, making it relatively more advantageous for businesses that retain their earnings to choose the corporate form. Subsequent changes in that relationship would alter the incentives that businesses face when they choose their organizational form.